

Compensation and related party disclosure

New rules for the 2007 proxy season

On Nov. 7, 2006, the new compensation and related party disclosure rules adopted by the U.S. Securities and Exchange Commission over the summer went into effect.¹ The new rules are a sweeping overhaul of the old disclosure rules, which were substantially rewritten and reorganized in an effort to make the disclosure clearer and easier for investors to follow, analyze and compare from year to year, and from company to company.

Companies will be required to comply with the new rules in their annual proxy statements and reports on Form 10-K for fiscal years ending on or after December 15, 2006. For calendar-year companies, this means that they will have to comply in the 2007 proxy season, which is fast approaching. Because of the significant changes to the rules, some of which are highlighted below, compliance will require a great deal of effort and diligence.

Compensation Disclosure. The new disclosure rules requires companies to provide more detailed information in their annual proxy statements about the compensation paid to their directors and named executive officers. Under the new rules, this category includes the chief executive officer, chief financial officer and the three most highly compensated executive officers other than the CEO and CFO. Companies will have to identify, describe and provide



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dollar values for each element of compensation that is awarded to or earned by these individuals, regardless of whether it has been paid. These might include cash and non-cash elements, such as stock and option awards, incentive payments and awards, deferred compensation payments and contributions, perquisites and personal benefits, termination and severance payments and benefits, retirement and pension benefits, including changes in pension values, and any earnings on the above items.

The disclosure rules relating to two of these items, options and perquisites/personal benefits, or perks, were significantly changed from the old rules in an apparent response to recent public attention and investigation into companies' practices relating to awards of these items.

The SEC redesigned the option disclosure rules to include information about all terms of stock options that are awarded. This will include, for example, the grant date and, if different, the date the board of directors took action with respect to the award, as well as a discussion of the company's practices in determining the exercise price, particularly when the exercise price differs from the market price. Furthermore, any policies or

decisions relating to the timing of option grants are required to be addressed in the new Compensation Discussion & Analysis section, which is discussed below. These new rules were adopted, not with the intention of encouraging or discouraging the use of options as a form of compensation, but rather to ensure that companies provide investors with full and fair disclosure of all elements involved.

Similarly, the SEC believes that information about perks may be material to investors and that the old rules permitted companies to omit too much important information. Therefore, the SEC adopted new rules that broaden the definition and substantially lower the disclosure threshold² for perks, making more types of perks subject to disclosure.



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The SEC's new rules require companies to disclose a figure for total compensation for each of the named executive officers and directors. Companies should be aware that the calculation for "total compensation" is the new determination method by which to identify the three highest paid officers (other than the CEO and CFO) for the "named executive officers" category. This new method is intended to more accurately reflect who, in fact, the highest paid officers are, because it not only takes into account salary and bonus, which were the only con-

siderations under the old rules, but also considers the value of the assortment of other potential compensation components that may be awarded as part of compensation packages.

Along with content changes, the SEC revised the disclosure format. The new rules require both tabular and narrative forms of presentation, which are intended to complement each other in order to create a comprehensive picture of the compensation packages awarded. The tables must state dollar values for each compensation element awarded, and provide other information, such as details about awarded equity that vested during, and is outstanding as of the end of, the fiscal year. The narrative sections, which must be presented in plain English, must discuss the underlying principles, and give detailed descriptions of the components, of compensation.

The primary narrative section under the new rules is the new Compensation Discussion and Analysis section (the "CD&A"). Similar to the Management's Discussion and Analysis section currently required in annual reports on Form 10-K, this new section is intended to be an overview of the company's compensation objectives, policies and decisions, and to answer the 'what, why and how' compensation packages are awarded. Companies are strongly cautioned not to repeat the information already disclosed in the tables, or to use boilerplate language, when drafting this section.

In addition, the information to be included in the Compensation Committee Report (the "CCR") has been modified. Instead of discussing the considerations and policies of the compensation committee in determining executive compensation packages, the SEC chose to redesign the CCR to be more like the Audit Com-

mittee Report, and now requires that it state whether the compensation committee discussed the CD&A with management and whether, based on this review, it recommended to the board that the CD&A be included in the company's annual report and/or proxy statement.

Under the new rules, the CD&A and CCR must be included in a company's proxy statement and annual report on Form 10-K, and companies are permitted to incorporate them by reference from their proxy statements to their Form 10-Ks. The CD&A will be considered "filed" rather than "furnished" with any filing in which it is included, and therefore subject to the liability provisions of the Securities Exchange Act of 1934, as amended. In contrast, the CCR will continue to be "furnished" to, rather than "filed" with, the SEC, except to the extent that it is specifically incorporated by reference into another filing. To the extent the CD&A and any other compensation disclosure is included in or incorporated by reference into a periodic report, the disclosure would be covered by the certifications that the CEO and CFO are required to make under the Sarbanes-Oxley Act of 2002.

Related Party Transactions. In order to provide investors with a more complete picture of financial arrangements between a company and its executive officers and directors, the SEC revised the rules regarding disclosure of related party transactions. These new rules broaden the scope of related party transactions, so that more types of financial relationships between a company and its executive officers, directors, significant shareholders and their immediate family members are subject to disclosure. These new rules are designed to make the disclosure clearer and easier for investors to follow, and require that the infor-

mation be presented in plain English.

A new rule under this item requires companies to describe the material features of their policies and procedures for reviewing, approving or ratifying related party transactions. The SEC's final rule release notes that certain state corporate laws and stock exchange listing standards require companies to have procedures in place for transactions that involve conflicts of interest, and the SEC believes that this information may be material to investors as well.

Other Amendments. The SEC consolidated the required disclosure of corporate governance matters into one item, and expanded the disclosure relating to director independence to include, among other things, the identities of each director and whether or not they are "independent," as well as a description of any transaction or relationship not disclosed as a "Related Party Transaction" that was considered in determining the director's independence. The SEC also made certain other related and conforming changes, including, among other things, changes to Form 8-K items relating to compensation arrangements, and to other rules and forms. For additional information about these requirements, please feel free to contact us.

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1. SEC Final Rule Release No. 33-8732; 34-54302 dated Aug.11, 2006, effective Nov. 7, 2006.
2. Under the new rules, disclosure of perks may be omitted if their aggregate value for a named officer or director is less than \$10,000, whereas the old rules permitted omission if their aggregate value equaled the lesser of \$50,000 or 10 percent of the total salary and bonus received for that fiscal year.